DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0030
Indiana Corporate Income Tax
For the Years 1995, 1996, and 1997

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ISSUES

I. Money Received From the Sale of Computers and Related Services to Indiana Remarketers – Gross Income Tax.

Authority: IC 6-2.1-2-2(a)(2); IC 6-2.1-3-3; IC 6-8.1-5-1(b); 45 IAC 1.1-2-5(a); 45 IAC 1.1-2-5(d); 45 IAC 1.1-3-3(c); 45 IAC 1.1-3-3(c)(5).

Taxpayer argued that the money it receives from selling computers and computer-related services to Indiana remarketers is not subject to gross income tax.

II. Investment Income – Adjusted Gross Income Tax.

Authority: IC 6-3-1-20; IC 6-3-1-21; IC 6-3-2-2(b); IC 6-3-2-2(g) to (k); May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); 45 IAC 3.1-1-29; 45 IAC 3.1-1-30.

Taxpayer maintains that money it earns from investing excess funds in an "investment portfolio" is entirely "non-business income" for purposes of determining taxpayer's adjusted gross income.

STATEMENT OF FACTS

Taxpayer is in the business of building and selling computers and computer software. Taxpayer has business locations and personnel within the state. During 1995, 1996, and 1997 taxpayer filed consolidated tax returns. During 2001, the Department of Revenue (Department) conducted an audit review of taxpayer's tax returns and business records. This audit review resulted in the assessment of additional corporate income taxes. Taxpayer disagreed with portions of the conclusions contained within the audit report and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer explained the basis for its report. This Letter of Findings is the result of that hearing, the supplemental information taxpayer supplied, and the information contained within the original audit report.

DISCUSSION

I. Money Received From the Sale of Computers and Related Services to Indiana Remarketers – Gross Income Tax.

Taxpayer sells its computers, software, and related services using a variety of methods including sales to two out-of-state "remarketers." Remarketer one was headquartered in California, and remarketer two was headquartered in Florida.

According to taxpayer, the sales to remarketer one were arranged in California with the equipment shipped from the point of manufacturer to the remarketer one's warehouse in Indianapolis.

According to taxpayer, the sales to remarketer two occurred in Florida with the computers being shipped to one of remarketer two's distribution centers located within Indiana.

Again – according to taxpayer – the taxpayer's in-state personnel were not involved in the sale of the computers, services, and associated software; the in-state personnel were not involved in the initiation, negotiation, or servicing of the either of these sales contracts.

The audit review assessed gross income tax on the money taxpayer received from remarketer one and from remarketer two at the "low" and "high" rates differentiating between the money taxpayer received for the sales of the computers and the money received for the provision of services related to those computers.

Gross income tax is imposed upon the "the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana." IC 6-2.1-2-2(a)(2). However, "Gross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution." IC 6-2.1-3-3.

Taxpayer argues that the money received from the sale of computers and services to the two remarketers is not subject to gross income tax because the underlying sales transactions were unrelated to the taxpayer's Indiana sales personnel and Indiana sales locations. 45 IAC 1.1-3-3(c) states that "Gross income derived from the sale of tangible personal property in interstate commerce is not subject to the gross income tax if the sale is not completed in Indiana." The regulation provides an example relevant to the specific issue raised by taxpayer.

> A sale to an Indiana buyer by a nonresident with an in-state business situs or activities but the situs or activities are not significantly associated with the sale because [the sale] was initiated, negotiated, and serviced by out-of-state personnel, and the goods are shipped from out-of-state. The in-state business situs or activities will be considered significantly associated with the sale if the sale is initiated, negotiated, or serviced by in-state personnel. 45 IAC 1.1-3-3(c)(5).

In order to establish that the sales to the two remarketers were not associated with taxpayer's Indiana sales location and taxpayer's Indiana sales personnel, taxpayer has provided affidavits, a letter, and a copy of an e-mail all attesting to the notion that the sales to remarketer one were not "initiated, negotiated, or serviced by in-state personnel." However, the information taxpayer provided relates only to sales of computers to remarketer one; the information provides no insight into the sales made to remarketer two. In addition, the information provided by taxpayer dates back to taxpayer's sales to remarketer one made during 1990 through 1992. The information does not relate specifically to the remarketer one sales made during 1995 through 1997.

The Department does not challenge the veracity or the good intentions involved the taxpayer's efforts to establish that the sale of computer made to remarketer one and remarketer two were unrelated to taxpayer's instate activity. However, pursuant to IC 6-8.1-5-1(b), taxpayer has not met its burden of "proving that the proposed assessment is wrong . . . ." Given the size, complexity, and dynamics of taxpayer's business, it is not possible to determine whether the 1995 through 1997 sales to remarketers one and two were similar in circumstances to the sales made to remarketer one during 1990 through 1992.

Taxpayer also argues that the money received from remarketer one and remarketer two – derived from the provision of computer services – was not subject to gross income tax because the services were related to the underlying interstate sales of computers. Taxpayer's argument misses the mark because whether or not the computers moved in interstate commerce is unrelated to the question of whether or not the income from the provision of services is subject to gross income tax. 45 IAC 1.1-2-5(a) provides that "Gross income derived from the provision of a service of any character within Indiana is subject to the gross income tax. This is true even when a service contract calls for the furnishing of tangible personal property in the performance of the contract." The same regulation further states that, "Gross income derived from the provision of a service within Indiana . . . on goods belonging to another is subject to gross income tax even though such property is moved in interstate commerce before or after the performance of the service." 45 IAC 1.1-2-5(d).

Taxpayer earned money because it provided services to remarketers one and two. Taxpayer provided the remarketers support documentation, advertising, and promotional materials. Taxpayer retained sales, warranty, and service records on behalf of the remarketers. Taxpayer conducted technical seminars and provided technical services for the remarketers. In consideration, the remarketers compensated taxpayer. That compensation is subject to the state's gross income tax.

<u>FINDING</u>

Taxpayer's protest is respectfully denied.

II. **<u>Investment Income</u>** – Adjusted Gross Income Tax.

The audit review found that money taxpayer earned in the form of "short term interest" constituted "business income." Taxpayer disagrees concluding that what it calls "Portfolio income" arose from transactions outside taxpayer's regular business activities and that the money should be classified as "non-business income." Taxpayer maintains that the acquisition of the securities "did not arise out of or were not created in the regular course of [taxpayer's] trade or business operations and the purpose for acquiring the holding the securities was not related to or incidental to such trade or business operations." As a result, taxpayer maintains that the portfolio/security income should be allocated to the state in which taxpayer's headquarters is found.

Taxpayer states that it maintains a "substantial investment portfolio composed of various types of interest-bearing and discount securities and money-market investments." The investment portfolio was devised as a means of safely and profitably investing surplus cash with the goal of obtaining the most attractive return possible; taxpayer states that investment decisions are based strictly on prevailing "economic and market conditions" and are unrelated to the needs of taxpayer's "regular trade or business." According to taxpayer, it maintains an investment department at its out-of-state headquarters and that all activities related to the management of the investment portfolio originate within this department. In order to manage its investment portfolio, taxpayer maintains a staff of personnel who have no duties or responsibilities within taxpayer's core business operation. Taxpayer describes that core business as the "development, manufacture, rental, sale and service of technical, commercial and scientific products, mainly data processing . . . and office equipment and a wide range of support and systems management services." In sum, taxpayer maintains a department and personnel, distinct from its core computer business, dedicated to investing taxpayer's surplus cash.

For purposes of determining a taxpayer's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three factor formula. IC 6-3-2-2(b). In contrast, non-business income is allocated to Indiana or it is allocated to another state. IC 6-3-2-2(g) to (k). Therefore, "whether income is deemed business income or non-business income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." <u>May Department Store Co. v. Indiana Dept. of State Revenue</u>, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001).

Taxpayer's argument, that this income constitutes "non-business income," is significant because if taxpayer is correct, all this income is allocated elsewhere and is not relevant in calculating taxpayer's Indiana adjusted gross income tax.

The benchmark for determining whether income can be apportioned is the distinction between "business income" and "non-business income." That distinction is defined by the Indiana Code as follows:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operation. IC 6-3-1-20.

"Non-business income," in turn, "means all income other than business income." IC 6-3-1-21. For purposes of calculating an Indiana corporation's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula, while non-business income is allocated to Indiana or another state in which the taxpayer is doing business. May, 749 N.E.2d at 656. In that decision, the Tax Court determined that IC 6-3-1-20 incorporates two tests for determining whether the income is business or non-business: a transactional test and a functional test. Id. at 662-63. Under the transactional test, gains are classified as business income when they are derived from a transaction in which the taxpayer regularly engages. The particular transaction from which the income derives is measured against the frequency and regularity of similar transactions and practices of the taxpayer's business. Id. at 658-59.

Under the functional test, the gain arising from the sale of an asset will be classified as business income if the acquisition, management, and disposition of the property generating income constitutes an integral part of the taxpayer's regular trade or business operations. *See* IC 6-3-1-20.

Department regulations 45 IAC 3.1-1-29 and 45 IAC 3.1-1-30 provide guidance in determining whether income is business or non-business under the transactional test. 45 IAC 3.1-1-29 states in relevant part that, "Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-30 provides that, "[f]or purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression 'trade or business' is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business, and derive business therefrom depending upon but not limited to some or all of the following:

(1) The nature of the taxpayer's trade or business.

(2) The substantiality of the income derived from the activities and the percentage that income is of the taxpayer's total income for a given tax period.

(3) The frequency, number of continuity of the activities and transactions involved.

(4) The length of time the property producing income was owned by the taxpayer.

(5) The taxpayer's purpose in acquiring and holding the property producing income.

The functional test focuses on the property being disposed of by the taxpayer. Id. Specifically, the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. May, 749 N.E.2d at 664. In order to satisfy the functional test, the property generating income must have been acquired, managed, and disposed by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. In May, the Tax Court defined "integral" as "part of or [a] constituent component necessary or integral to complete the whole." Id. at 664-65. The court concluded that petitioner retailer's sale of one of its retailing divisions was not "necessary or essential" to the petitioner's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not the petitioner. Id. at 665. In effect, the court determined that because the petitioner was forced to sell the division in order to reduce its competitive advantage, the sale was not integral to the petitioner's own business operations. Id. Therefore, the proceeds from the division's sale were not business income under the functional test. Id.

The audit correctly concluded that the money received from the portfolio investments was "business income." The information offered by taxpayer itself demonstrates that it regularly engages in the sale and purchase of securities in order to maximize the value of its surplus cash assets. The sales and purchase of securities is such an ordinary part of taxpayer's business that it maintains a separate business division and hires personnel specifically dedicated for that purpose. The investment proceeds are properly classified as "business income" pursuant to the transactional test.

In addition, the income is properly classified as business income under the functional test because the sale and purchase of securities constitutes an integral part of the taxpayer's business. Therefore, the income meets the "functional test." Although taxpayer may be correct in stating that it is in the computer business and not the investment business, that distinction is irrelevant. The issue is not whether or not taxpayer is in the investment business, the issue is whether the investment income is "business" or "non-business" income. In this instance, there is nothing extraordinary taxpayer's investment of excess cash in order to maximize the value of that cash. To the contrary, the practice appears to be a day-to-day part of taxpayer's overall business; the investment income is neither unusual nor unexpected and falls squarely within the definition of "business income."

FINDING

Taxpayer's protest is respectfully denied.

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